Senate Finance Committee

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The Final Report of the President's Commission to Strengthen Social Security

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Chairman Baucus, Senator Grassley, and members of the Committee, thank you for inviting me to discuss the final report of the President's Commission to Strengthen Social Security. I am here representing the Concord Coalition, a nonpartisan grassroots organization dedicated to strengthening the nation's long-term economic prospects through sound and sustainable fiscal policy.

Concord's co-chairs are former senators, Warren B. Rudman (R-NH) and Bob Kerrey (D-NE). They, along with Concord's President former Commerce Secretary Peter G. Peterson and our nationwide membership, have consistently urged Washington policymakers to produce a credible plan for dealing with Social Security's long-term challenges in a fiscally responsible and generationally equitable manner. Given this objective, The Concord Coalition welcomed the appointment of the President's Commission.

My testimony today will address three questions:

- Is Social Security reform necessary?
- What are the viable reform options?
- What are the main achievements and shortcomings of the Commission's report?

I. Is Social Security reform necessary?

Absolutely. Changing demographics make the current pay-as-you-go system fiscally unsustainable and generationally inequitable over the long-term. Social Security reform is on the political agenda not because President Bush wants to change the law but because the law must be changed.

In just six years the baby boomers begin to receive their first Social Security checks. From that moment on, the number of workers whose wages are taxed, relative to the number of beneficiaries who receive the proceeds of the tax, will sharply decline. Here are the facts:

- In 1960 there were 5 workers for each Social Security beneficiary. Today the ratio is 3.3 workers for each beneficiary. As the huge baby boom generation retires the ratio will fall to 2 to 1.

- This dynamic has a profound effect on the system's fiscal sustainability. Social Security will generate ample surpluses for the next few years. But in 2009, the year after the first baby boomers qualify for benefits, the annual cash surplus will begin to shrink, and by 2017 Social Security's cash flow will turn negative.

- From 2017 through 2041 Social Security will need to draw upon interest income and eventually liquidation of its trust fund assets—special issue Treasury bonds—to pay benefits. In 2041, the trust fund will be depleted, leaving Social Security with enough annual income to pay just 74 percent of benefits.

- Redeeming Social Security's trust fund assets will have an impact on the rest of the budget because these "assets" are liabilities to the Treasury. To come up with the money for Social Security, Treasury will have to cut other spending, raise taxes, use any surpluses that may exist, or borrow from the public.

- Between 2017 and 2041, the year of projected trust fund insolvency, the system faces a cumulative cash deficit of more than $5 trillion in today's dollars. By 2041 the annual cash deficit will reach $360 billion in today's dollars — an amount roughly the size of this year's entire national defense budget.

- Closing the gap in 2041 would require a Social Security tax hike of 34 percent or a 27 percent cut in benefits.

- Over the trustees' 75-year horizon Social Security's cash deficit of $22 trillion in today's dollars far outweighs the cash surplus of roughly $1 trillion through 2017.

- As a percentage of the economy Social Security will grow by 50 percent from 4.46 percent today to 6.70 percent in 2041.

- More importantly, this growth in Social Security's cost will take place in the context of rising costs for other entitlements. The combined cost of Social Security, Medicare, and Medicaid will grow from less than 10 percent of the economy today to nearly 17 percent by 2050. And this assumes no additions to the current programs such as a Medicare prescription drug benefit. By comparison, all of government this year equals 19.5 percent of GDP, and revenues equal about 19 percent.

- This trend leads to one of three outcomes: large tax hikes, resurgent and unsustainable deficits, or the withering away of the rest of government — allowing spending on the poor, on infrastructure, and on defense to steadily decline decade after decade. No one believes that the federal government's sole function should be to transfer income to retirees at the expense of all other government functions. But that is the inevitable consequence of adhering to two widely held-and entirely contradictory-goals: limiting the size of government and leaving senior benefits on autopilot.

Suppose that one of your colleagues introduced legislation called "The Social Security Do Nothing Act." Under this bill, promised retirement benefits would be cut by 16 percent for today's 30-year olds, by 29 percent for today's 20-year olds, and by 35 percent for today's newborns. Alternatively, payroll taxes would suddenly go up by 34 percent in 2041. How many of you would rush to endorse this bill? None, I suspect. And yet, these are the grim choices under the Do Nothing Plan.

What is remarkable is not that reform plans engender such heated debate, but that the Do Nothing Plan engenders so little outrage. Worse yet is the fact that no one will have to endure the scrutiny and ridicule of specifically advocating the Do Nothing Plan in order for its absurd consequences to take effect. The Do Nothing Plan has already been enacted. It is current law.

The question facing you is the same one that faced the Commission — what should be done to undo the Do Nothing Plan? Ultimately it is you, our elected leaders, who must answer this question.

Now is the time to begin preparing for the aging of America by designing a retirement system that is both more secure for the old and less burdensome for the young. Demographic and economic circumstances will never again be so favorable for Social Security reform. However, the window of opportunity is rapidly closing.

To put it in more personal terms, consider the table below which looks at where four different generations will be at various times in their lives relative to Social Security's current outlook. What may sound like a distant and abstract problem becomes more immediate and relevant when we consider that today's 28-year old will qualify for full retirement benefits in 2041 — the year of projected trust fund insolvency — and that the system will begin to run growing annual cash deficits even before today's newborn enters the workforce.

Ages of Persons in Four Generations at Significant Dates for the Social Security Program				
2002	2017[1]	**2041[2]**	2050[3]	2076[4]
90 years old	105 years old			
60 years old	75 years old	**99 years old**	108 years old	
30 years old	45 years old	**69 years old**	78 years old	104 years old
Newborn	15 years old	**39 years old**	48 years old	74 years old

1. In 2017, Social Security's dedicated revenues will no longer cover all of its expenses. At this point Social Security will become a net drain on the budget as it begins to draw upon its claims on general revenues. The pay-as-you-go tax rate will be 13.07 — up from 10.84 today. Including Medicare Part A, the payroll tax cost rate will be 16.37.

2. In 2041, all of the assets in the Social Security trust fund will be exhausted, leaving the program able to pay only 74 percent of promised benefits. The pay-as-you-go tax rate will be 17.76 percent of taxable payroll. Including Medicare Part A, the tax rate will be 24.05.

3. In 2050, the Congressional Budget Office estimates that the cost of Social Security, Medicare and Medicaid combined will consume nearly 17 percent of GDP, almost all total federal revenues assuming that taxes remain at about 19 percent of GDP. The pay-as-you-go tax rate will be 17.92 percent of taxable payroll. Including Medicare Part A, the tax rate will be 25.08.

4. 2076 is the last year of official 75-year projection. By then the program will be able to pay just 68 percent of that year's promised benefits. The pay-as-you-go tax rate will be 19.84 percent of taxable payroll. Including Medicare Part A, the tax rate will be 30.62.

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The table above underscores an important point: Social Security reform is a much more critical issue for today's young than today's elderly. The current system is more than adequate to meet its obligations to those who are already retired. However, the system can't possibly afford all of the benefits it promises to today's workers. Those with the greatest stake in this debate are therefore the so-called Gen X'ers and younger, and it is this segment of the population most overlooked in the Social Security reform debate. It is a big mistake.

Public opinion surveys have indicated declining confidence in Social Security over the past 25 years. Many younger workers are beginning to discount Social Security entirely in their retirement planning. This decline in public confidence is itself a major problem for a system that depends critically on everyone's approval and trust. Social Security is a generational compact in which each generation's welfare depends directly upon the willingness of the next generation to participate. If the next generation grows disaffected, the survival of the system is thrown into question.

II. What are the viable options for reform?

The Social Security challenge is first and foremost a cost challenge. Any responsible reform plan must start with measures that reduce the projected growth in benefits and makes the system fiscally sustainable over the next 75 years and beyond.

But reducing Social Security's cost is not the only challenge. There are also the issues of benefit adequacy and individual equity. Reform must ensure that future retirees have adequate benefits. It must also ensure that workers do not pay an ever-rising payroll tax burden in return for ever-diminishing paybacks on contributions. Reform needs to raise the return on Social Security contributions.

This is why The Concord Coalition believes that, along with measures to reduce its long-term cost, greater funding is an essential part of Social Security reform. To make a difference, however, the funding must be genuine. It isn't enough to simply credit more Treasury bonds to the trust funds or to redirect existing payroll contributions into marketable securities, with or without personal accounts.

Without ***new*** savings, without ***real*** funding, a plan cannot increase the productivity of tomorrow's workers, and thus becomes a zero-sum game of pushing liabilities from one pocket to another or from one generation to another. It cannot be supposed that funding more of Social Security's benefits is a way to avoid the hard choices. *It is the hard choice.*

In recent years, much attention has been given to various methods of advance funding future benefits. Suggestions include:

- a budgetary "lockbox" for the Social Security surplus
- an independent board to mange trust fund investments
- personally owned accounts

While ideological factors often cloud the debate over these options, the real issue is which is most likely to result in genuine savings. What legal, political and fiscal incentives best ensure that resources are actually reallocated from the present to the future?

Lockboxes

The main drawback of trying to prefund through a trust fund lockbox is that the trust funds are a matter of intergovernmental bookkeeping. When the Social Security trust funds run a surplus, the money is lent to the Treasury, which immediately spends it. In return, the trust funds are credited with interest –earning Treasury bonds. These transactions are entirely internal to government and are designed to keep track of formal budget authority. They give Social Security a lien on future taxpayers but they do not create real economic resources that can pay future benefits.

It is true that over the past few years political leaders buoyed by huge surplus projections reached a tacit agreement to increase savings through debt reduction by keeping the budget balanced excluding Social Security's trust fund receipts. Devoting the Social Security surplus to debt reduction is a fiscally responsible goal but it is easier said than done - as events over the past year have made clear. Regardless of intent, and despite any bookkeeping devices such as a lockbox, the government can only save the Social Security surplus if it continues, year after year, to take in more money than it needs to pay all of its other bills without dipping into the Social Security trust funds. This has only happened twice from 1983 to the present, and is not projected to happen again for many years.

Success of the lockbox concept is therefore critically dependent on the willingness of future political leaders to maintain a level of fiscal discipline that is not currently discernable.

Investment by an independent board

To get around the porous nature of trust fund lockboxes, some have proposed to set up a Social Security reserve fund administered by an independent trustee and invested in marketable securities. This mechanism would probably provide a more reliable method than the lockbox for promoting savings but here too, there are important questions. What would prevent the federal government from borrowing against its own Social Security investments? When all is said and done, government would still own the reserve, and whatever government owns it can contrive to spend. Moreover, the public would have no particular incentive to ensure that the savings are genuine because Social Security's defined benefit promise is not contingent on the system's fundedness.

Personally owned accounts

A third method of prefunding is to establish a system in which some portion of workers' payroll tax contributions are saved and invested in personally owned accounts. The advantage of this method is that it would provide a lockbox no politician could pick. The current system provides a *statutory* right to benefits that Congress can cut at some future date. Personally owned accounts would offer workers ownership of constitutionally protected property which could be passed on to their heirs — something the current system does not allow. The funds would be put beyond the reach of government. Congress could not double-count personal account assets in the budget. And if it tried to shut down the flow of funds into personal accounts, voters would have a huge incentive to object.

The transition cost

Transitioning out of the current pay-as-you-go system into a partially funded system, with or without personally owned accounts, inevitably requires some group of workers to pay for the pre-funding of the new system while at the same time maintaining funding for those still receiving benefits under the old system. There is no avoiding this cost. Workers will thus have to save more, retirees will have to receive less, or both.

The fundamental issue is not whether the system should be public or private, but the extent to which it should be unfunded or funded. Unfunded personally owned accounts would neither add to national savings nor reduce the burden of today's system on future generations, even if they earn a higher rate of return than the current pay-as-you-go system. The fiscal and economic effects of debt-funded personal accounts are no different from the effects debt-funded trust funds. Both avoid the real challenge, which is to ensure that adequate resources are set aside to meet the cost of future benefits.

Investment in higher return assets might provide a way to mitigate the extent of benefit cuts or tax increases that might otherwise be required. However, no conceivable rate of return on investments, standing alone, would be enough to fund currently projected benefits at today's contribution rate. Indeed, this proposition is confirmed by the Commission's Model One, which does nothing more than dedicate 2 percent of the current payroll tax to personal accounts. As the report states, under this approach, "Workers, retirees and taxpayers continue to face uncertainty because a large financing gap remains requiring future benefit changes or substantial new revenues."

Finally, it should be emphasized that despite the vitriolic rhetoric often surrounding Social Security reform, a widespread consensus exists that any viable plan will probably include some combination of benefit cuts, increased contributions, higher returns and general revenues. Each involves trade-offs and each comes with a fiscal and political price, regardless of whether it aims to prop up the existing pay-as-you-go system or aims at transitioning to a partially prefunded system.

III. What are the achievements and shortcomings of the Commission's Report

The Commission's suggested reform plans have not been presented to the public or to Congress as take-it-or-leave-it propositions. Indeed, the Administration itself has not said which of the three model plans it prefers, if any. In assessing the Commission's report, therefore, one need not accept or reject its proposals in whole. At this point, a better approach is to make constructive suggestions for improvement — keeping in mind that change must come and that there are no magic bullets.

Report's main achievements

- **The Commission recognized that reform must pursue fiscal sustainability**

The Commission rejected the "free lunch" approach to reform. One finding of the Commission's final report states: "There are many paths to fiscal sustainability. All of them require some combination of changing the rate of benefit growth or committing additional revenues generated by taxation or by the proceeds of investment."

The Commission further observed, "Social Security's fiscal problems exist independently of the debate over whether personal accounts should be part of a reformed system. With or without personal accounts, policymakers must answer a fundamental question: how much of the nation's output should be spent on government support of senior citizens? Those who believe that the share devoted to the elderly should continue to consume a larger and larger share of the nation's output have a responsibility to identify where the money will come from. Those who believe that growth in spending should be restrained have a responsibility to explain how exactly they would change Social Security's benefit structure to achieve this."

This is very sound advice to guide the reform debate.

- **The Commission explained the flaws of trust fund accounting**

It is often said that Social Security's problems are far off in the future because the program can pay full benefits until 2041. The Commission appropriately rejected this notion and explained that the fiscal and economic consequence of Social Security's fiscal shortfall will begin to show up long before its official insolvency date of 2041.

Trust fund solvency says nothing about fiscal sustainability. The trust funds are a matter of intergovernmental bookkeeping. Their assets consist of Treasury IOUs that can only be redeemed if Congress raises taxes, cuts other spending, uses surpluses if any exist, or borrows from the public. Thus, their existence, alone, does not ease the burden of paying future benefits. If trust fund solvency were all that mattered, Congress could instantly credit the trust funds with sufficient paper assets to keep them solvent for any length of time imaginable.

A related argument based on trust fund accounting is that a tax hike of merely 1.87 percent of payroll is all that is needed to restore Social Security to long-term solvency. This claim is based on the program's actuarial balance, which averages projected trust-fund surpluses and trust-fund deficits over the next seventy-five years. In 2002, Social Security's actuarial balance was a shortfall of 1.87 percent of payroll. In theory, this is the amount that Congress would have to raise FICA taxes or cut Social Security benefits, starting immediately, in order to keep the trust funds solvent until 2076.

On the surface, a tax hike of 1.87 percent of payroll sounds small, but it is equivalent to a roughly 10 percent increase in everyone's personal income taxes. More importantly, the solution is not permanent: It assumes that the horizon for trust-fund solvency will forever remain fixed at seventy-five years from today. In other words, it assumes that while we would require the trust funds to be in balance over a full seventy-five years, our children will be satisfied with forty years and our grandchildren will be satisfied with an empty cupboard. Correcting this "cliff effect" is a necessary element of credible reform.

But there is a more fundamental problem. As noted above, any trust-fund surplus is immediately lent to Treasury, leaving Congress free to spend the money it is supposedly saving. For the 1.87 percent solution to ease Social Security's burden on the economy, legislators would have to allow the program's extra interest-earning assets to accumulate unspent for decades — a proposition that seems unlikely and in any event cannot be guaranteed.

Fiscally, what really matters is Social Security's operating balance — that is, the annual difference between its outlays and its dedicated tax revenues. Trust fund accounting sidesteps the real issue, which is not how to meet some official solvency test, but how to ensure Social Security's fiscal sustainability and generational fairness.

- **The Commission advocated advanced funding and increased savings**

The Commission report aptly states, "Advance funding raises national savings, increasing the nation's capital stock and productive capacity and reducing Social security's financial burden on future generations….To ensure that Social Security's financing burdens are equitably shared, it is imperative that a portion of these revenues be devoted to advance funding. The resulting increases in national saving will raise the country's capital stock, and therefore boost our productivity and output. In essence, increased national savings increases the size of the economic pie that is available for everyone, old and young alike, to consume in the future."

- **The Commission raised the possibility of "add-on" contributions to personal accounts**

One approach to funding personal accounts is to add new mandatory contributions on top of the existing payroll tax (i.e., an "add-on" plan). Model Three in the Commission's report provides for a small voluntary add-on to help fund personal accounts. While the overall design of Model Three is rather confusing and its funding inadequate, the idea of an explicit add-on contribution is worth exploring further.

In general, the Commission chose the other prominent approach to funding personal accounts — a "carve-out" that redirects a portion of the existing payroll tax. The two approaches differ in the trade-off they make between two objectives:

- A pure carve-out approach guarantees that no extra compulsory contributions of any kind will be added to the Social Security system. But there is an unavoidable trade-off in not requiring any new contributions. While it is possible for a carve-out plan to give workers bigger benefits than the current system can afford, it is not possible for it to give workers bigger benefits than the current system promises. The Commission's models confirm this.

- The add-on approach meets a different objective. Increased funding can make it possible for every worker to be at least as well off in total benefit dollars in retirement under the new system as under the old. In effect, an add-on can fund the unfunded promises of the current system. The much better benefit adequacy possible with an add-on option is not without a cost—namely, the extra contributions required of all workers.

No reform plan can fund currently promised benefits at the current contribution rate — and still abide by honest accounting and prudent assumptions. Is it worth paying a bit more to achieve superior results? In the end, after all the shell games are played out, this is the central choice the American public must confront.

- **The Commission distinguished between what current law promises and what it can afford**

Because the current system is substantially under financed, the proper comparison for any reform plan is between the benefits payable under a reformed system and the benefits payable under the Do Nothing plan. Some have argued that the Commission's plans would result in deep benefit cuts when compared to the current system in a hypothetically solvent condition. This is neither fair, nor realistic. No realistic reform plan looks good when compared to the false hypothetical of a perfectly solvent system. It is fundamentally unfair to judge any reform plan against a standard that assumes the current system can deliver everything it promises. It can't. Today's Social Security system promises far more in future benefits than it can possibly deliver.

Moreover, in assessing the adequacy of benefits under a reformed system that includes personal accounts it must be kept in mind that a person's retirement income would come from *both* sources—a basic level of benefits from the defined benefit portion and the additional benefit financed from the lifetime accumulation of the personally owned account. In comparing benefit levels the entire benefit of a reformed system must be included.

- **The Commission did not duck the need for cost savings**

Perhaps the Commission's most positive contribution to the debate is its clear statement that current-law benefits are unsustainable and will have to be reduced in the future. The Commission acknowledged that meaningful reform will require meaningful trade-offs. Two of the Commission's cost-saving proposals in particular—price indexing (Model Two) and longevity indexing (Model Three) — merit serious consideration.

(1) <u>Price indexing:</u> Under current law, initial benefit awards are indexed to wages—that is, the wage history on which benefits are based is updated at the time of retirement to reflect the rise in the economy's overall wage level over the course of the beneficiary's working career. In effect, wage indexing ensures that the living standard of retirees keeps pace with society's overall living standard. Re-indexing initial benefit awards to prices merely ensures that the absolute purchasing power of retirees keeps up with inflation. Note that this reform effects only initial benefit awards; current benefits are already price indexed.

The reform has two advantages: its simplicity and its large savings. If real wages are growing 1 percent per year faster than inflation, price indexing will result in a roughly 35 percent cut in initial benefits relative to current law for the first cohort to spend a complete career under the new regime. Under this assumption, the savings would be roughly sufficient to close Social Security's long-term cash deficit.

Under current law, closing Social Security's deficit would require an enormous acceleration in productivity growth. Yes, higher productivity would result in higher wages and this would boost payroll tax revenue. But higher wages would also result in higher benefits, and this would largely cancel out the gain. With price indexing,

however, benefits would shrink dramatically and indefinitely relative to taxable payroll and GDP—and the faster wages grow, the more benefits would shrink as a share of the economy.

This dynamic, of course, means that the living standards of retirees will diverge from those of the working population. To the extent that we view Social Security as a pure floor of projection, this does not pose a public policy problem. To the extent that we view it as an income replacement program, it does. This is why wage-indexing makes most sense as part of an overall reform that also incorporates funded benefits like personal accounts. The price indexed pay-as-you-go benefit would ensure that the absolute living standard of each new generation of retirees matches the living standard of the previous generation. The funded benefits would help ensure that the relative living standard of retirees is not eroded. The rate of return to a funded system, after all, is the rate of return to capital—and historically, this has been faster than the rate of growth in wages.

This is precisely what the UK is doing. In a series of reforms beginning in the 1980s, Great Britain's venerable Basic State Pension was price indexed while access to funded pensions, including occupational plans and personal accounts, was expanded. As a result, the UK is now the only industrial country that faces little or no long–term cost challenge due to the aging of its population. While the UK reform was initiated by the conservative government of Margaret Thatcher, it has been endorsed by Labour under Tony Blair.

(2) Longevity indexing. Social Security retirement benefits are paid in the form of a defined benefit annuity. An annuity purchased with a defined contribution personal account balance would naturally take into account expectations about future longevity. The more years the annuity provider expects to have to pay benefits, the smaller the annual benefit a given account balance would buy. The current Social Security system makes no such adjustment. The benefit annuity it promises is set by a formula that yields the same result no matter how fast and far life expectancy rises. Cutting benefits by a fixed percentage may balance the system for a while. But unless reform also adjusts benefits for ongoing gains in life expectancy, the system will drift out of balance again.

The impact of rising longevity on Social Security's long-term cost is large. Over the next 75 years, the Trustees project that life expectancy at 65 will rise from 17.4 to 21.7 years, or by 25 percent. Over the long run, this 25 percent rise in life expectancy will translate into a roughly equivalent percentage rise in total benefits. The Trustees' projection, moreover, assumes that longevity will increase more slowly in the future than it has in the past. If the historical trend continues, the impact on Social Security costs will be even greater.

There are two ways to index Social Security to longevity. The minimum eligibility age for benefits could itself be indexed—that is, the early retirement age could be raised in tandem with average life expectancy. Or else—and this is the approach the Commission took—annual benefits could be reduced so as to offset the greater number of years that will be spent collecting those benefits. This is the equivalent of indexing the so-called normal retirement age, the age at which full or unreduced benefits are payable.

There is a logic to longevity indexing that reaches beyond the need for programmatic cost savings. Americans live longer and healthier lives than we did a generation ago—yet we retire earlier. Over the postwar era, more than all of the nation's "longevity dividend" has gone into extra years of retirement, none into extra years of work. That may have seemed affordable back when the baby boom was in the workforce, but it won't be when the boomers retire.

At least two countries have recognized the importance of longevity indexing for stabilizing the long-term cost of pay-as-you go systems. In the 1990s, major public pension reforms in Italy and Sweden included provisions for longevity indexing. Germany and a number of other countries are considering this reform.

Report's main shortcomings

While The Concord Coalition agrees with many of the Commission's findings, particularly those regarding fiscal sustainability and advance funding, we do not endorse any of the three reform plans as proposed by the Commission. Model Two comes the closest to meeting the goal of fiscal sustainability, but its 4 percent "carve out" structure would put a substantial near-term drain on the budget, particularly in the absence of surpluses, and its need for large scale general revenue financing calls into question it's integrity over the long-term. For the numbers to add-up, the defined benefit cuts would need to be phased in sooner. Without additional contributions, the plan cannot afford to grandfather (as it does) every worker over 55. Alternatively, the plan could fill the gap with new revenues, for instance through a modest personal accounts add-on along the lines included in Model three.

In the spirit of constructive criticism we offer the following observations:

- **The Commission's plans are not adequately funded**

The most basic question to ask of any reform plan is whether or not, if implemented, Social Security would still run out of money. None of the Commission's plans meet this standard. Ignoring new general revenue transfers, they all go bankrupt by 2030.

In Model One, after bankruptcy Social Security's cash deficits widen into the indefinite future. As the report agrees, Model One comes nowhere near sustainability (indeed, it is only a slight improvement over current law). Its primary purpose in the report may be simply to illustrate the arithmetic of personal accounts.

Models Two and Three both technically remain solvent throughout the valuation period (i.e., the next 75 years) but only because they authorize the transfer from Treasury of whatever sum might be needed on an annual basis to prevent the trust fund ratio from falling beneath 100 percent. In addition, Plan 3 includes a special schedule of general revenue transfers that are set in advance. All of this comes on top of the draw down of existing trust fund assets.

It is true, as the Commission report asserts, that over the next 75 years both plans reduce Social Security's long-term general revenue requirement relative to current law. Under

current law, Social Security's cumulative cash deficit from 2001 to 2075 is projected (according to the 2001 Trustees report) to be $22.7 trillion. In Plan 2, it is projected to be $7.0 trillion; in Plan 3, $9.8 trillion. All figures are in constant 2001 dollars. The relative advantage of the reform Plans over current law is similar if we take into account timing by discounting deficits to present value. The corresponding PV figures are $5.1 trillion (current law), $2.8 trillion (Plan 2), and $3.3 trillion (Plan 3). The same is true if we calculate the figures net -- that is, if we include years where Social Security is running a cash surplus. Here the PV figures are $4.2, $2.2, and $2.8 trillion, respectively.

The bottom line, however, is that the Commission's plans don't pay for themselves or put Social Security on a sustainable basis. Plan 3 obviously does not. Under this plan, Social Security is still running a cash deficit at the end of the period. Unless new tax revenue is raised to liquidate the transition debt, it will be a permanent and growing burden throughout the indefinite future. Plan 2 ultimately results in a growing cash surplus. But even here, it is not clear that the surplus is large enough or growing fast enough to pay off the transition debt.

There is another important issue regarding funding that needs to be reconsidered -- namely, the Commission's provision for open-ended general revenue transfers. Yes, if all goes according to expectations, Plans 2 and 3 improve the outlook relative to current law. But what if things don't? The Plans will still have short-circuited trust-fund discipline – even as they render the system permanently "solvent." Experience with the Medicare part B trust fund, which has an open pipeline to the Treasury for 75 percent of program costs, should be enough to make policymakers avoid any similar arrangement with Social Security.

Keep in mind that we're not talking about just a few years of additional borrowing. In the case of Model Two, the borrowing would commence in 2025 and last all the way to 2054 (29 years); in the case of Model Three, it would commence in 2034 and last all the way to 2065 (31 years). And keep in mind as well that all of this borrowing will start just after Social Security has already consumed all of its trust-fund assets—a liquidation which will itself burn a big whole in the federal budget. In fact, under either option, the deficit impact on the federal budget will begin immediately and last until the 2040s, that is, for nearly half a century. In addition to all this, moreover, Model Three calls for a further and explicit drain on the federal budget in the form of a permanent and unborrowed "annual general revenue transfer" (equal to nearly one percent of worker payroll).

The report implies that this long and massive borrowing, which it calls "temporary transition financing," is affordable because Social Security will be able to pay it back out of cash surpluses in the distant future. But even assuming the future unfolds exactly according to the report's projections, the question must be asked: Are these surpluses big enough? The report does not answer this question.

Apparently, the Commission assumed that any finite negative number in the medium-term future would be overwhelmed by a growing positive number in the long-term future. However, the negative number will be compounding at an interest rate that exceeds both

the growth rate of GDP and the growth rate of the later surpluses. In the report, the Commission emphasizes the "magic" of compound interest. But this magic, when you're talking about debts rather than assets, quickly becomes a nightmare.

- **A personal account system should be mandatory**

Given that Americans like the idea of choice, voluntary participation may be a political selling point. While the Commission was directed by the President to develop a voluntary plan, The Concord Coalition believes that mandatory participation is necessary to boost national savings, maintain progressivity within the system, and ensure that workers build meaningful assets in their personally owned accounts. To date, voluntary savings incentives such as 401(k) plans and Individual Retirement Accounts (IRAs) have met with mixed results. This experience is evidence that participation in any new system must be mandatory to ensure that personal savings will actually increase.

In a more fundamental sense, moreover, mandatory participation is basic to the concept of Social Security as a universal system of social insurance. Government has a legitimate interest in seeing that people do not under-save during their working lives and become reliant on safety net programs in old age. Moving toward personal ownership need not and should not mean "privatizing" Social Security.

This voluntary requirement hugely complicates and confuses the Commission's report. It forces the report to present each reform-package option as a spectrum of results between two extreme outcomes (everyone choosing to opt in versus everyone choosing to opt out). The report then shows that retirees will fare well under reform—but only if they choose to opt in. This presents an unresolved paradox. If the Commission were sure of its projections, why would anyone be allowed the "choice" to opt out and be a loser?

Before enacting a system of voluntary accounts it is important to ask: Do we really want Americans to sort themselves into two vast interest groups—one making a cosmic economic and policy bet going one way, and the other making a bet going the other way? Furthermore, why is "choice" important in a compulsory floor-of-protection plan whose primary function is to protect people against poor choices?

Social insurance should not be a crapshoot. In the Commission's framework, voluntary accounts allow people to "choose" to bet on an outcome (defined benefits doing better than personal accounts) which the Commission is meanwhile assuring everyone cannot happen. The question must be asked: If, for the sake of choice, Group A is allowed to experience outcomes much worse than for Group B, then why does our system of compulsory contributions maintain a much higher floor-of-protection for group B? If what we are forcing Group A to save is sufficient, then what we are forcing Group B to save is excessive. Why not reduce the required contribution, force everyone to invest at Group B's rate of return, ensure that everyone has a benefit outcome like Group A's, and then leave everyone free to do what they want with the extra money outside of Social Security?

None of this is to suggest that personal accounts don't have a role to play in Social Security reform. But the best argument in their favor is that given any menu of contribution hikes and defined-benefit cuts, a personal accounts component will certainly maximize future benefits while minimizing the risk of improper or improvident fiscal accounting; it will probably boost national savings and increase public confidence in the system; and it may even improve the odds that voters will embrace reform. None of these arguments suggest that accounts must be voluntary to be successful. Just the opposite.

IV. Conclusion: Generational responsibility requires that prompt action be taken.

The rationale for reforming Social Security now has nothing to do with today's retirees or those who are about to retire. For them, there is no crisis. What's at stake is the retirement security of future generations — those who have many working years ahead, or who have yet to enter the workforce. For them, doing nothing is the worst option. The issue is what makes sense for the world of 2035, not what made sense in the world of 1935.

The longer reform is delayed, the worse the problems inherent in the current system will become and the more difficult they will be to remedy. Delay risks losing the opportunity to act while the baby boom generation is still in its peak earning years, and the trust fund is running an ample cash surplus. Squandering this opportunity would be an act of generational irresponsibility.

We should stop playing political shell games with this issue. If we do not have the political will to solve the Social Security problem now, there is no hope of doing so when the baby boomers start collecting benefits — not just for Social Security but for Medicare and Medicaid as well. The problems facing our health care programs are much more daunting and difficult than Social Security. These three programs together are expected to double as a share of the economy within 30 years, putting unthinkable pressure on tax rates, the economy and the budget.

Not acting is itself a choice — one that has grim consequences for today's midlife adults and even bigger ones for their children. Politicians of both parties should get behind specific reform plans or be held accountable for supporting the consequences of the Do Nothing Plan.

APPENDIX A

“The Social Security Shell Game,” by former Senators Bob Kerrey (D-NE) and Warren B. Rudman (R-NH), *Washington Post,* August 12, 2002.

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Wall Street's slump and the disappearing budget surplus are shaping this year's campaign rhetoric on Social Security reform. It's easy to see why. These events have taken two cherished free-lunch options off the table. Politicians can no longer claim that investment returns from a never-ending bull market or general revenue transfers from perpetual budget surpluses will save them from making hard choices.

This development should spark a more realistic debate on genuine reform options. But the clear danger is that without a free lunch to promise, politicians will fall back on an equally bad option: the Do Nothing Plan. Voters shouldn't let that happen. In just six years the baby boomers will begin receiving Social Security checks. Then, the number of workers whose wages are taxed, relative to the number of beneficiaries who receive the proceeds of the tax, will begin to decline sharply. Before Tiger Woods turns 50, the number of beneficiaries will grow by at least two-thirds, while the number of workers will barely budge. Doing nothing means deep benefit cuts or steep payroll tax increases for future generations, which is why the Social Security trustees warn that prompt action is essential.

Suppose that a member of Congress introduced legislation called "the Social Security Do Nothing Act." Under this bill, promised retirement benefits would be cut by 16 percent for today's 30-year-olds, by 29 percent for today's 20-year olds and by 35 percent for today's newborns. Alternatively, payroll taxes would go up by roughly 40 percent in 2041. How many politicians would rush to endorse this bill? And yet these are the choices under the Do Nothing Plan.

Today's political heat is primarily aimed at three reform plans produced by the president's Commission to Strengthen Social Security. Critics argue that the commission's plans would result in deep benefit cuts, fiscally irresponsible general revenue transfers and undue risk, when compared with the current system in a hypothetically solvent condition.

It is certainly fair to criticize reform plans on policy grounds. But it is fundamentally unfair to judge them against a standard that assumes the current system can deliver everything it promises. It can't. Today's Social Security system promises far more in future benefits than it can possibly deliver. The relevant comparison for any reform plan is with what current law can deliver, not what it promises.

No realistic reform plan looks good when compared with the false hypothetical of a perfectly solvent system. Reformers have the burden of saying what changes they would make to a system that is popular but unsustainable. Critics can sit back and take pot shots at politically painful options without having to say what they would do instead.

We have a simple suggestion to improve the dialogue. Critics of the commission's proposals should come up with their own plans for shoring up Social Security. They should be specific about the benefit cuts and tax increases they recommend and the amount of general revenues that would be required. A real debate then could take place -- not one between the commission's plans and an impossible ideal but between the commission's plans and the plans of its critics.

The public should ask: How does each plan affect total benefits, total taxes and different beneficiaries -- the retired, disabled and survivors? How will each plan affect national savings? What are the risks? Do the plans provide the resources to pay for promised benefits, or do they just balance the fund on paper? Do they make Social Security permanently sustainable?

We should stop playing political shell games with this issue. If we do not have the political will to solve the Social Security problem now, we can't hope to do so when the baby boomers start collecting benefits -- not just for Social Security but for Medicare and Medicaid as well. The problems facing our health care programs are much more daunting than Social Security. These three programs together are expected to double as a share of the economy within 30 years, putting unthinkable pressure on tax rates, the economy and the budget.

Not acting is itself a choice -- one that has grim consequences for today's midlife adults and even bigger ones for their children. Politicians of both parties should get behind specific reform plans or be held accountable for supporting the consequences of the Do Nothing Plan.

Bob Kerrey, a former Democratic senator from Nebraska, and Warren B. Rudman, a former Republican senator from New Hampshire, are co-chairs of the Concord Coalition.

APPENDIX B

Reform Criteria

In assessing whether Social Security reform proposals face up to the real issues or merely conceal or shift problems under the pretense of solving them, The Concord Coalition suggests that reform plans be evaluated using the following criteria:

- **Does it improve net national savings?** Given demographic trends, the economy in the future will be called upon to transfer a rising share of real resources from workers to retirees. These resources will be much easier to find in a healthy growing economy than in a stagnant one. The best way to achieve economic growth and increase real income in the future is to increase savings today. Savings provide the capital to finance investments, which will enhance productivity and increase the amount of goods and services each worker can produce. Without new savings reform is a zero–sum game.

- **Does it focus on fiscal sustainability rather than trust fund solvency?** Trust fund solvency is the wrong goal because it is unrelated to the cost of future benefits or to the manner in which sufficient resources will be found to afford this cost. For example, the trust funds could be made perpetually "solvent" by granting them additional Treasury bonds, or by crediting them with higher interest on the existing bonds. Such actions would improve trust fund solvency, but they would not make the program any more affordable for future workers. Fiscally, what really matters is Social Security's operating balance — that is, the annual difference between its outlays and its dedicated tax revenues. Trust fund accounting sidesteps the real issue, which is not how to meet some official solvency test, but how to ensure Social Security's fiscal sustainability and generational fairness.

- **Does it rely on a hike in the FICA tax?** Hiking payroll taxes to meet benefit obligations is neither an economically sound nor generationally equitable option and will fall most heavily on the middle class. Younger Americans in particular may be skeptical of any plan that purports to improve their retirement security by increasing their tax burden and by further lowering the return on their contributions.

- **Does it rely on new debt?** Paying for promised benefits or the transition to a more funded Social Security system by issuing new debt defeats the whole purpose of reform. To the extent that plans rely on debt financing, they will not boost net savings. And without new savings, any gain for the Social Security system must come at the expense of the rest of the budget, the economy, and future generations. Resort to borrowing is ultimately a tax increase for our kids.

- **Does it rely on outside financing?** Unrelated tax hikes and spending cuts may never be enacted, or if enacted, may easily be neutralized by other measures. Unless the American public sees a direct link between sacrifice and reward, the sacrifice is unlikely to happen.

- **Does it use prudent assumptions?** There must be no fiscal alchemy. The success of the plan must not depend upon large perpetual budget surpluses or lofty rates of return on privately owned accounts. All projections regarding private accounts should be based on long-term historical averages, a prudent mix of equity and debt, and realistic estimates of new administrative costs.

- **Does it maintain the system's progressivity?** While individual equity ("moneysworth") is important, so too is social adequacy. Social Security's current benefit formula is designed so that benefits replace a higher share of wages for low-earning workers than for high-earning ones. Under any reform plan, total benefits, including benefits from personal accounts, should remain as progressive as they are today.

- **Does it protect participants against undue risk?** Under the current system, workers face the risk that future Congresses will default on today's unfunded pay-as-you-go benefit promises. While reducing this "political risk," reform should be careful to minimize other kinds of risk, such as investment risk, inflation risk, and longevity risk — i.e., the risk of outliving ones assets.

- **Does it keep Social Security mandatory and preserve a full range of insurance protection?** The government has a legitimate interest in seeing that people do not under-save during their working lives and become reliant on the safety net in retirement. Moving toward personal ownership need not and should not mean "privatizing" Social Security. Any new personal accounts should be a mandatory part of the system. Moreover, Social Security does more than write checks to retirees. It also pays benefits to disabled workers, widows, widowers, and surviving children. A reformed system must continue to provide these important insurance protections.